No. 21003

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PASADENA INVESTMENT COMPANY and WILLIAM J. CLARK,

Appellants,

vs.

MARGUERITE J. WEAVER,

Appellee.

APPELLANTS' OPENING BRIEF.

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McLAUGHLIN & McLAUGHLIN,
650 South Spring Street,
Suite 1224,
Los Angeles, Calif. 90014,

Attorneys for Appellants, Pasadena Investment Co. and William J. Clark.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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Statement of Pleadings and Facts Disclosing Jurisdiction.

Appellee, Marguerite J. Weaver, a widow, filed a petition for an arrangement under Chapter XI of the Bankruptcy Act (Secs. 707-799, Title 11, U.S.C.A.). No Receiver was appointed, and it will be shown that there was nothing which a Receiver could have taken custody of, in any event, because her primary asset was a fifty-five acre ranch near Tulare, California, which was under a term lease to a tenant and also a term sub-lease to a sub-tenant. [R.T. p. 57, line 26, to p. 58, line 1.]

After filing the above proceedings, the Appellee debtor, on July 7, 1965, filed a petition for an order restraining a trust deed sale under a trust deed, wherein Appellant Pasadena Investment Co. was beneficiary, Title Insurance and Trust Company was trustee, and Appellee and her deceased husband were trustors, se-

curing a $51,000.00 promissory note. [T. p. 61, lines 5-25.] Appellant William J. Clark was joined as a holder of such note, it being conceded that he acquired his ownership after it became due. [T. p. 62, line 26, to p. 63, line 20.]

The Debtor's petition did not specify the jurisdictional grounds for the relief sought, but it proceeded upon the ground that a restraint of the trust deed was essential to prevent the loss of the main asset of the Debtor's estate, and on the ground that the trust deed had been procured by fraud on the part of Pasadena Investment Co.

At the inception of the hearing before the Referee (The Honorable Donald R. Franson), the question of his jurisdiction to proceed was argued at length by Appellants through their then attorneys, even to the extent that some of their contentions, such as the argument that the Probate Court had exclusive jurisdiction, may not have been tenable.

In any event, the Referee summed up the arguments on jurisdiction as follows:

> "For the record, in addition to the petition that was filed, the respondent Pasadena Investment Company has filed an answer and—in which they deny the essential allegations of the petition; they are also objecting to the jurisdiction of this court—with reference to any portion of this property, which was in the course of being probated in the estate of the debtor's deceased husband. The court will rule on that matter of jurisdiction at the proper time." [R.T. p. 1, line 23, to p. 3, line 5.][1]

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[1]Reference herein to "R.T." means the transcript of the oral proceedings held before Referee Franson. Reference to "T." means the Transcript of the Record certified to by William B. Luck, Clerk.

In discussing this subject, the Referee said:

> "This court will acknowledge right here, that you properly objected to jurisdiction, there will be no suggestion that anybody's consented to jurisdiction." [R.T. p. 6, lines 19-22.]

In further elucidation of his position, the Referee stated:

> "I would suggest to counsel that this whole procedure might be shortened if we proceed to present the case, having in mind your objection of jurisdiction is preserved, and I will rule on that at the conclusion of the testimony but I don't mean to dictate to you, how you want to present your case." [R.T. p. 16, line 22, to p. 17, line 1.]

After hearing arguments from counsel on this subject, the Referee stated:

> "Your Arguments have been well made here, your objections to jurisdiction are duly entered, you haven't consented to jurisdiction so, I would at this time request Mr. Dietrich to proceed with his case on the merits." [R.T. p. 76, line 25, to p. 77, line 2.]

Following this hearing at which substantial conflicting testimony was received, the Referee, on November 15, 1965, signed Findings of Fact, Conclusions of Law and an Order declaring the note and trust deed void as to Appellee, and her deceased husband, and directing that the same be surrendered up by Appellants for cancellation as to such two parties, but not as to Appellee's son, Charles L. Weaver, Jr. [T. pp. 57-67.] In this decision, the Referee determined that, "This Court has jurisdiction to determine the validity of the note

and trust deed." [T. p. 63, lines 24 and 25.] No reference to any statute or authorities was contained therein.

On November 19, 1965, Appellants filed a Petition for a Writ of Review with the Clerk of the United States District Court, pursuant to Section 39 of the Bankruptcy Act (Sec. 67(c), Title 11, U.S.C.A. as amended to July 14, 1960, 74 Stat. 528.)

This petition for review was argued before the Honorable M. D. Crocker, United States District Judge, after having been extensively briefed, and on March 29, 1966, he rendered his decision, the full text of which is as follows:

> "Marguerite J. Weaver, as debtor in possession under Chapter XI proceedings, petitioned for an order to show cause to determine validity, nature, extent, priority and amount of claims of lien.
>
> "Both petitioners claimed a lien upon real property, title to which was in the name of debtor and her deceased husband. Debtor was executrix of the Will of her husband, and under the terms of the Will she was the devisee of her husband's interest in the property. The property was leased to a tenant and petitioners therefore claim it was not in the possession of debtor and thus the Referee didn't have jurisdiction.
>
> "Although counsel argues that petitioners waived their objection to jurisdiction, I don't reach that question.
>
> "Debtor was the owner of the property when she filed her petition for arrangement.
>
> "As devisee, the interest of her husband vested in her at the time of his death which was prior

to her petition. As owner, she was in constructive possession of the property at the time she filed her petition, even though the actual possession was by her tenant.

"Thus the Referee had jurisdiction to determine the validity of the liens.

"There is ample evidence in the record to support the findings and conclusions of the Referee which are hereby adopted by the court and his order reviewed herein is affirmed." [T. p. 1622.]

Jurisdiction is conferred upon this Court of Appeals to determine the issues raised by this appeal under Section 24a of the Bankruptcy Act (Sec. 47a, Title 11, U.S.C.A.)

See:

Collier Bankruptcy Manual (Second Edition), p. 351, for discussion and citations.

See also:

Section 1291, Title 28, U.S.C.A.

Statement of the Case.

This is an appeal from a judgment of the United States District Court (S.D. Cal. N.D.) affirming an order of the Referee in Bankruptcy which restrained a trust deed foreclosure sale on a fifty-five acre ranch near Tulare, and which held a $51,000.00 note and such trust deed void as having been obtained by the fraud of two officers of Appellant, Pasadena Investment Co.[2]

[2]With respect to the two Appellants, Pasadena Investment Co. and William J. Clark, any reference in this brief to "Appellant" shall mean Appellant Pasadena Investment Co., and when the word "Appellants" is used, it shall include both Appellants.

The proceeding in which the Referee made such order and determination had been filed by Appellee, as the Debtor, under Chapter 11 of the Bankruptcy Act. (Secs. 701, *et seq.*, Title 11, U.S.C.A.)

We have noted that the evidence upon which the Referee made his determination of fraud was sharply conflicting, but we are not seeking a review of any such conflict. We mention it in order to emphasize that Appellants had substantial, and not merely colorable, rights which Appellants were entitled to have determined in a plenary action with appropriate pleadings and all essential parties before a court of competent jurisdiction.

The opinion of the Honorable M. D. Crocker, District Judge, sustained the jurisdiction of the Referee on the ground that the Appellee Debtor was the owner of the ranch, and although not in actual possession, the court ruled that the Debtor was in "constructive possession", in spite of the fact that the ranch was in the actual possession of the sublessee under a term lease and a subsequent term sublease to a man named Turk. [T. p. 1622; R.T. p. 57, line 21, to p. 58, line 1.] No authorities were cited in support of this "constructive possession" theory.

In the concluding paragraph of its opinion, the District Court seems to regard the case as one where it had been asked to review a finding upon conflicting evidence, when the only aspect was that there had been conflicting evidence on the issue of fraud. In other words, this defense was not merely a colorable one, but a substantial one which could not be summarily litigated without the consent of all parties.

Additionally, there was an even broader ground of absence of jurisdiction. This was the absence of jurisdiction in a Chapter 11 proceeding to adjudicate the validity or invalidity of liens on property of a debtor.

The above two points on lack of jurisdiction will be considered under separate subdivisions of this brief. The specification of errors will be very brief, but we will, first, briefly summarize the facts so that this Court may have a clearer picture of the manner in which these questions arose.

The promissory note and deed of trust had been signed and delivered by the Appellee, by her husband, Charles L. Weaver, Sr. (now deceased) and by Charles L. Weaver, Jr. The Appellee alleged in her petition that the promissory note and deed of trust had been obtained by Appellant, Pasadena Investment Co., by means of fraud in the inducement, and the Debtor claimed and testified that an officer of Pasadena Investment Co. had stated to her that the $51,000.00 note represented a loan made by Pasadena Investment Co. to be used to finance the operation by Mid-Valley Development Co. in a feed brokerage business to be managed by her son, Charles L. Weaver, Jr. [R.T. p. 46, line 10.]

Appellant, William J. Clark, was also made a Respondent in the above-mentioned petition, for the reason that he held title to the promissory note and deed of trust and was alleged to be proceeding to foreclose the trust deed and enforce the note through a sale by Title Insurance and Trust Company, the Trustee under such deed of trust.

The Referee, in his Findings, determined that William J. Clark was not a holder in due course of the

promissory note and ruled that the note and deed of trust were void as to the Debtor, Marguerite J. Weaver, and her deceased husband, Charles L. Weaver, Sr. He, therefore, ordered that the promissory note and deed of trust be delivered up to be cancelled as to Marguerite J. Weaver and Charles L. Weaver, Sr. [T. pp. 57-67.]

All of the foregoing relief was granted, pursuant to the Appellee's petition above mentioned, after a hearing which commenced on the 20th day of August, 1965, before the Honorable Donald R. Franson, Referee in Bankruptcy. [T. p. 57.]

During the hearing before the Referee, there was extensive argument regarding the jurisdiction of the Referee to proceed to determine the validity or invalidity of the promissory note and deed of trust. There was also a special defense of estoppel which was urged as against Appellee because of her delay in taking any proceedings to have the note and deed of trust declared void for fraud, and because of the fact that all three signers of the note, which was dated August 28, 1963, had subsequently signed a letter dated July 23, 1964, reaffirming their liability under such promissory note and deed of trust. A copy of this confirming letter is attached to the Answer of Appellant, William J. Clark, and marked Exhibit "C" thereto. [T. p. 39.]

At this place, we should observe that, although we believe that the estoppel defense is good as to Appellant William J. Clark, who purchased the promissory note after seeing this confirmation [T. p. 62, line 18, to p. 63, line 20], we are not urging the defense of estoppel as to Pasadena Investment Co.

This appeal is not to obtain a review of conflicting evidence, so the only importance of a further statement of facts is to show that there was a substantial bona fide issue as to whether any representative of Pasadena Investment Co. had perpetrated a fraud.

The Referee found that Charles L. Weaver, Jr., the Debtor's son, violated his contractual duties to Pasadena Investment Co., by allowing cattle to be taken from the feed yards, without the feed bills for such cattle having been paid [T. p. 58, line 29, to p. 59, line 16], which thereby resulted in the agistors' liens, for such feed bills upon such cattle, being lost.[3]

See:

Civil Code, Sec. 3051.

At this time, the feed bills, which were secured by such agistor's liens, had been factored (sold) by Hume Lake Cattle Co. to Pasadena Investment Co., with the result that such accounts (previously secured by the agistor's lien) totaling $68,036.67, were left without security, and remained unpaid by the various cattle ranchers whose cattle had been in the feed lot before being released to their owners by Charles L. Weaver, Jr. Thereupon, Charles L. Weaver, Jr. signed and delivered to Pasadena Investment Co. his unsecured promissory note dated May 7, 1963, in the sum of $68,036.67, and Pasadena Investment Co. reassigned to Charles L. Weaver, Jr. the then unsecured invoices evidencing the feed bills totaling $68,036.67. At the same time, Hume Lake Cattle Co. signed and delivered an unsecured promissory note dated May 8, 1963, in the sum of

[3]The statements contained herein are covered by the Findings of Fact, p. 3, line 2, to p. 5, line 22.

$68,036.67 to Charles L. Weaver, Jr., who, in turn, assigned it to Mid-Valley Development Co. as a part of the same transaction. About that time, Pasadena Investment Co. entered into a recourse factoring agreement which was guaranteed by Charles L. Weaver, Sr. Weaver, Jr., acting in his capacity as President of Mid-Valley Development Co., then assigned this promissory note of Hume Lake Cattle Co. to Pasadena Investment Co., and directed Pasadena Investment Co. to apply the $51,027.50 purchase price, which it was paying, toward the payment of the personal note to Pasadena Investment Co. The Referee found all of this to be without the knowledge or permission of Charles L. Weaver, Sr. [T. p. 61, lines 5-27.]

Charles L. Weaver, Jr. was an officer and employee of Hume Lake Cattle Co. and was also a guarantor of Hume Lake's factoring agreement with Appellant. Additionally, he was an employee of Appellant for the purpose of releasing cattle from the corrals when their owners had paid off their feed bills. [T. p. 58, line 31, to p. 59, line 3.] This function which he performed was similar to that performed in connection with security warehousing, where an employee of the borrower is designated as agent of the warehouse receipt owner to release warehoused merchandise when the warehouse lien thereon has been discharged.

See:

Heffron v. Bank of America (9th Cir.), 113 F. 2d 239; and

McCaffey Canning Co. v. Bank of America, 109 Cal. App. 415 at 436.

No controversy existed as to the liability of Hume Lake Cattle Co. on the $68,036.67 note which it gave

to Charles L. Weaver, Jr. or as to Weaver, Jr. also being liable to Appellant for having wrongfully released the cattle without having received payment on the $68,-036.67 feed bills. [T. p. 59, lines 3-14.] Appellee does challenge the act of Appellant in using the $51,027.50[4] purchase price which Appellant was to pay Mid-Valley Development Co. for the Hume Lake Cattle Co. note to Charles L. Weaver, Jr., which Mid-Valley Development Co. transferred to Appellant as a factoring transaction. Although there was no explicit finding to that effect, it is conceded that the $51,027.50 purchase price of Appellant was never delivered to either Charles L. Weaver, Jr. or to Mid-Valley Development Co. Instead, it was used by Appellant to discharge the liability of Weaver, Jr. and Hume Lake Cattle Co. to Appellant. This is the essence of Appellee's claim of fraud, because she testified that an officer of Appellant had told her that the $51,027.50 would be used to provide working capital to Mid-Valley in its business of feeding cattle.

Also, it should be noted that the Findings of Fact are that the assignment and factoring of such promissory note to Pasadena Investment Co. was not in the regular course of business of Mid-Valley Development Co., in that it was normally set up to factor (sell) feed bills for the feeding of cattle. Additionally, the Referee found that Weaver, Jr. did not have any authority to pay his personal obligation to Pasadena Investment Co. with an asset of Mid-Valley Development Co., to wit, the $51,027.50 sales price of the Hume Lake Cattle Co. note, which would otherwise have been

[4]The Findings sometimes refer to the sum as $51,027.50 and, at other times, as $51,000.00, but this difference is of no importance.

receivable by Mid-Valley Development Co. According to the Findings of the Referee, Appellant was lending $51,000.00 to Mid-Valley Development Co. to be used in its feed brokerage business, managed by Weaver, Jr., and as a result thereof, the Appellee and Weaver, Sr. signed the $51,000.00 promissory note and trust deed on their land to secure such promissory note, under the belief that the same was to be used in the feed brokerage business of Mid-Valley. The Referee found that the $68,036.67 Hume Lake note was not an "account" within the meaning of accounts which Mid-Valley was authorized to factor or sell, and that Weaver, Jr. had no right to use the proceeds from the sale of an asset of Mid-Valley (the $68,036.67 note of Hume Lake or the $51,027.50) to pay Weaver, Jr.'s personal debt to Appellant. [T. p. 59, line 15, to p. 61, line 6.]

The Referee also found that a representative of Appellant had fraudulently represented to the Debtor and to Weaver, Sr. that the $51,000.00 loan to Mid-Valley was to be used for working capital by Mid-Valley. [T. p. 59, line 15, to p. 61, line 6.]

The Referee did not find that Appellant Clark was a party to any such fraud, but that he had had past business dealings with Pasadena Investment Co., and that Pasadena Investment Co. had falsely represented to him that the check from Pasadena Investment Co. in the sum of $51,000.00 was the consideration paid by Pasadena Investment Co. for the $51,000.00 note and deed of trust. The Referee further found that Clark made no inquiry to the makers of the note before he purchased it, and that Appellant is financially solvent and capable of making full restitution to Clark for any

loss by reason of his purchase of the note. [T. p. 63, lines 13-21.]

There was no Finding with respect to whether Weaver, Jr. was a party to the fraud of Appellant, and, yet, his participation in this fraud, if any fraud existed, is inescapable. He testified that he had requested the representative of Appellant (Perkins) to explain to the two Weaver, Srs. the transaction under which a check was being drawn by Appellant payable to the order of Mid-Valley. [R.T. p. 227, line 20, to p. 228, line 12.]

In other words, Weaver, Jr. attempted to escape responsibility for any fraud by testifying that he did not personally explain the real purpose of this transaction to his parents but that he requested Perkins to do so. It is incredible that, after signing the note and deed of trust on August 28, 1963, Weaver, Jr. would continue to operate Mid-Valley in the feed brokerage business and to successfully conceal from his parents the fact that the $51,027.50 paid by Appellant had actually been used to repay the unpaid portion of the Hume Lake note. In any event, he would have had to be a party to the initial fraud, as well as to the concealment of the facts which took place thereafter, until around the month of June, 1965, when a Notice of Rescission was sent by Mrs. Weaver, the Debtor.

It is likewise difficult to understand how Weaver, Jr. and his parents could have failed to discuss this transaction for a period of approximately two years after it took place, bearing in mind that there was no showing of any unfriendliness between Weaver, Jr. and his parents. The subject must have come up between the parties during this long period of time, as Weaver, Sr. was also financially interested in Mid-Valley and

its operations. [R.T. p. 234, line 25, to p. 235, line 5.] In addition to this, both Appellee and her now deceased husband signed a letter approximately one year later, wherein they confirmed that their $51,000.00 note was a valid obligation of theirs. [T. p. 39.]

Appellants' Specification of Errors.

1. The District Court erred in determining that it did not need to decide whether the Referee in Bankruptcy had jurisdiction to declare Appellants' trust deed lien void, for the District Court's stated reason that the Appellee Debtor was in constructive possession of the ranch property involved.

2. Such Court erred in determining that the lessor (the Debtor) under a term lease was in constructive possession, in spite of such lease and in spite of the fact that physical possession was exclusively in a sublessee (Turk) of the lessee (Charles Weaver, Jr.).

3. Lack of jurisdiction of the Referee to proceed summarily was not waived by Appellants.

4. The District Court erred in failing to take cognizance of another limitation upon the jurisdiction, which is imposed by Sections 307 and 357 of the Bankruptcy Act. (Secs. 707 and 756, Title 11, U.S.C.A.)

5. The District Court erred in failing to rule that Appellee was estopped o challenge the enforcibility of the note and trust deed as to its assignee, William J. Clark.

6. Because the defense of fraud was based upon substantial evidence, a decision on the questions of jurisdiction should have been made by the District Court.

The first two specifications will be dealt with under a single subdivision of this brief.

ARGUMENT.

I.

The Lessor, Appellee, Did Not Have Any Constructive Possession of the Ranch Which She and Her Deceased Husband Had Leased to Their Son, Charles L. Weaver, Jr., Since 1958.

Charles L. Weaver, Jr. had thereafter subleased the property to a Mr. Turk. [R.T. p. 57, line 23, to p. 58, line 2.]

The Referee, in deciding that he had jurisdiction did not rely upon any theory that a lessor has constructive possession. In any event, we do not believe that such a theory of constructive possession has any basis for application in this case.

Volume 2 of Collier on Bankruptcy (14th Ed.), states that there was "some authority" that a tenant has only a "colorable" claim which could be adjudicated in a summary proceeding. It then states the predominant rule, at page 519, as follows:

> "The better view, however, is that a *bona fide* lessee of the bankrupt's property, who is in possession of the property on the date of bankruptcy, has a substantial adverse claim thereto, which, if asserted, must be determined in a plenary suit in the proper forum, and that the bankruptcy court has no jurisdiction to adjudicate such a claim without the consent of the lessee. The Supreme Court had indicated that in a controversy with his lessor, the possession of the lessee may be independent.
>
> "Where a lease, as in the usual case, conveys to the lessee the right to the use and enjoyment

> of the property for a specified period, it can hardly be contended that the lessee does not have a substantial interest in the property adverse to that of the bankrupt lessor, nor can the fiction of a constructive possession be raised to overcome the fact of actual possession by the lessee, maintained under a claim of right."

In *Foodtown of Oyster Bay, Inc. v. Delbert's Leasing & Devel. Corp.,* 334 F. 2d 768 (2d Cir.), the court in disapproving the trustee's contention that claims as between the landlord, bankrupt and the lessee were subject to summary jurisdiction, said at page 769:

> "The appellee is mistaken in contending that possession by the lessee confers constructive possession on the lessor so as to permit exercise of summary jurisdiction; to the contrary, possession by the lessee under an initially valid lease is hostile to possession by the lessor. See 2 Collier, Bankruptcy, Sec. 23.06(12)."

In re Mt. Forest Fur Farms of America, 122 F. 2d 232 (6th Cir.), the trustee sought to enjoin an oil lessee from carrying on oil drilling operations. The debtor had a 1/8th interest and the lessee a 7/8ths interest. After citing numerous cases limiting the summary jurisdiction of the bankruptcy court, the court stated the rule, at page 243, as follows:

> "A mineral lessee may maintain his possession against his lessor as effectively as against any other person. State ex rel. Jennings-Heywood Oil Syndicate v. DeBaillon, 113 La. 572, 37 So. 481, 483. This Louisiana case was quoted and followed

in Pan American Petroleum Co. v. United Lands Co., 5 Cir., 96 F. 2d 26, 28. The Circuit Court of Appeals commented upon the effect of this Louisiana decision: 'A lessee in possession thus may defend his possession against the world, including the lessor * * *."

The rule that a lessor has no constructive possession of the leased property is well established in California. In 30 Cal. Jur. 2d (Landlord and Tenant), the rule is stated at page 249:

> "Immediately on commencement of the term, unless special reservation is made, a tenant succeeds to all the rights of the landlord that are annexed to the estate, so far as possession and enjoyment of the premises are concerned. He is entitled to take possession under the lease at any time before his term expires. And when the tenant takes possession the landlord parts with all his right to possession of and control over the premises."

See also:

Walther v. Sierra R. Co., 141 Cal. 288, at 291;

Flynn v. Hite, 107 Cal. 455 at 460; and

Yee Chuck v. Stanford, 179 Cal. App. 2d 405 at 410.

In Volume 8A of Words and Phrases at pages 584 to 587, the general rule stated in the citations therein is that constructive possession does not exist, except where a third party is holding possession through no right or claim of his own, but as an agent for the owner.

In *Glens Falls Insurance Co. v. Strom* (U.S.D.C. S.C.), 198 Fed. Supp. 450, the court said at page 456:

> "Thus, we conclude that since there were adverse claims against the proceeds of the two policies, the policies or the proceeds therefrom, were not in the constructive possession of the bankruptcy court prior to the deposit in this Court."

None of the circumstances for permitting a summary determination exist in the case at bar, such as the following:

1. Situations where the rights asserted by the adverse party were merely colorable and did not have sufficient substance to merit their being litigated (*In re Engineers Oil Properties,* 72 Fed. Supp. 989);

2. Situations where a claimant had voluntarily consented to the summary proceedings by filing an unqualified claim with the bankruptcy court and thereby submitting to the jurisdiction (See *Glens Falls Etc. v. Strom* (*supra*) at page 458 and *2 Collier on Bankruptcy,* 14th Ed., pp. 524, *et. seq.*); and

3. Some instances where the trustee has actual possession of the property or fund which is in dispute and which possession he has obtained by voluntary action of the adverse claimant or by voluntary action of the bankrupt (*Long Beach v. Metcalf* (9th Cir.), 103 F. 2d 483).

II.

The Referee's Lack of Jurisdiction to Proceed Summarily Was Waived.

We have already quoted, from Referee Franson, to the effect that he did not believe that the point on lack of jurisdiction had been waived.

Rule 15(b) of the *Federal Rules of Civil Procedure* contains the following provision:

> "When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings."

Also, it has been held that the right to have plenary litigation may be raised at any time before the entry of the final judgment. This rule is stated in *8 Corpus Juris Secundum,* Bankruptcy, Sec. 342(16), at page 647, as follows:

> ". . . that participation in summary proceedings by an adverse claimant does not constitute consent to the exercise of such judication provided formal objection to summary jurisdiction is made before entry of the final order."

See also:

> *In re Burofsky* (D.C. Mass.), 64 Fed. Supp. 128, at 130.

Since neither the Referee nor the Judge of the District Court has sustained any contention that Appellants might have waived their right to object to the summary jurisdiction, there is no purpose of dwelling further on this subject.

III.

Chapter 11, in Dealing With Arrangements Such as the Proceeding Filed by Appellee, Specifically Restricts the Jurisdiction of the Bankruptcy Court to Unsecured Creditors.

Section 356 of the *Bankruptcy Act* (Sec. 756, U.S.C.A., Title 11) states:

> "An arrangement within the meaning of this chapter shall include provisions modifying or altering the rights of unsecured creditors generally or of some class of them, upon any terms or for any consideration."

Section 307 of the *Bankruptcy Act* (Sec. 707, U.SC..A., Title 11) provides:

> "Unless inconsistent with the context and for the purposes of an arrangement providing for an extension of time for payment of debts in full and applicable exclusively to the debts to be extended—
>
> "(1) 'creditors' shall include the holders of all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 103 of this title and whether liquidated or unliquidated, fixed or contingent; and
>
> "(2) 'debts' or 'claims' shall include all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 103 of this title and whether liquidated or unliquidated, fixed or contingent."

The rule is stated in *Collier Bankruptcy Manual*, page 1089, as follows:

> "Only unsecured debts may be affected by an arrangement; mortgages or other liens cannot be modified, reduced or extended under Chapter XI."

In *Chaffee County Flourspar Corporation v. Athan,* 169 F. 2d 448 (Tenth Circuit), a petition for arrangement under Chapter XI was filed, and the only assets of the debtor listed were a note in the amount of $140,000.00, secured by a deed of trust on certain mining property, and an $8.00 deposit in the bank. The arrangement proposed percentage payments over a period of a number of years. It appeared that, among the secured debts, there were judgments against the debtor, as well as notes secured by deeds of trust and chattel mortgages. The Court noted that the only asset of the debtor "hangs by the thread of the stay order, for without it the sheriff's deed becomes effective and the note worthless." The Court then affirmed the judgment of the District Court, approving an order of the Referee dismissing the arrangement proceedings. In this connection, it said at page 450:

> "Since, however, only the right of unsecured creditors of the debtor may be arranged, Securities & Exchange Commission v. United States Realty & Improvement Co., 310 U.S. 434, 60 S. Ct. 1044, 84 L.Ed. 1293, the court should not exercise its injunctive powers in a manner to alter the rights of the secured creditors of the debtor. See Collier on Bankruptcy, 14 Ed., Vol. 8, Sec. 3.22, p. 186. If adequate relief cannot be granted without affecting the rights of the secured creditors, the Bankruptcy Act has provided an adequate remedy in Chapter X and elsewhere in the Act. See Securities & Exchange Commission v. United States Realty & Improvement Co., supra; John Hancock Mutual Life Ins. Co. v. Casey, 1 Cir., 141 F. 2d 104."

In *In the Matter of Coyle John Tracy,* 194 Fed. Supp. 293, United States District Court, N.D. California N.D., a secured creditor petitioned for review of an order restraining the sale of the debtor's residence and place of business. The District Court held that there was not sufficient evidence in the record to determine whether the Referee should have restrained the foreclosure sale pending the further investigation as to whether the debtor had a substantial equity in the property, and it remanded the case back to the Referee for further proceedings to determine this matter. In recognizing the limited powers of the Bankruptcy Court to restrain the enforcement of liens pending a determination as to whether there was a substantial equity or as to whether the property can be disposed of for an amount in excess of that required to discharge the lien, the Court said at page 295:

> "A Chapter XI proceeding may arrange only the rights of unsecured creditors, without alteration of the rights of secured creditors (Bankruptcy Act, section 306(1), Title 11 U.S.C.A. section 706 (1); and Securities & Echange Commission v. United States Realty Co., 310 U.S. 434, 60 S. Ct. 1044, 84 L. Ed. 1293). Nevertheless, the court may, upon notice and for cause shown, stay or enjoin any act to enforce a lien upon the property of a debtor (Bankruptcy Act, Sec. 314, Title 11 U.S.C.A. Sec. 714). The exercise of this power lies within the discretion of the Referee, and his decision to exercise such power must be sus-

tained unless he has abused that discretion (In re Laufer, 2 Cir., 230 F. 2d 866). The exercise of such discretion is, however, subject to equitable consideration, and care should be taken to insure that the stay will cause no substantial injury to the lienor (See Collier on Bankruptcy, 14th ed., Vol. 8, at p. 189; and Chaffee County Flourspar Corp. v. Athans, 10 Cir., 169 F. 2d 448).

"* * *

"This proceeding is strictly an arrangement of a Debtor's difficulties with his unsecured creditors. Its objective is to pay his unsecured creditors in an orderly and expeditious manner, and to keep him, if possible, from being put out of business by his unsecured creditors. This is not a proceeding to rearrange priorities between his secured and unsecured creditors or to handle his difficulties with *secured* creditors. The Court has the power to restrain sale of the property in question under the deeds of trust, only if necessary to facilitate the primary purpose of this proceeding, and if it does not cause substantial injury to the lienor (See Chaffee County Flourspar Corp. v. Athan, supra)." (Italics theirs.)

In the case at bar, the Court was not determining whether there was an equity or whether the debtor might be able to dispose of the property in a sum sufficient to pay the lien holder. It was proceeding to determine, and it did make a final determination, that

the Appellant's note and deed of trust were void. In other words, it imposed a final determination and remedy, which it had no power to do.

In *In re Potts,* 47 Fed. Supp. 990, United States District Court, E.D. Kentucky, the Referee, in a Chapter XI proceedings, denied the debtor's claim of offset against the claim of a secured creditor. The Court referred to the statutes which we have already cited herein, and said at page 992:

> "Since it appears from the record in this proceeding without dispute, that the claim of the creditor H. H. Potts was adequately secured by a lien upon the debtor's real estate, his rights as such creditor were not affected by the debtor's proposed arrangement with her unsecured creditors. No order having been entered enjoining the enforcement or foreclosure of his lien upon the debtor's property (section 314, 11 U.S.C.A. sec. 714), he is and was at all times free to enforce his lien without obstruction or interference arising from this proceeding.
>
> "On account of the limited scope of arrangement proceedings under Chapter XI of the Act, it seems clear that the referee erred in assuming jurisdiction to adjudge or determine, in this proceeding, questions involving conflicting claims between the debtor and her secured creditor and in holding that the failure of the secured creditor to accept the proposed arrangement necessarily precluded consideration of it, if in other respects the requirements of Chapter XI were met."

In *Securities & Exchange Commission v. United States Realty Co.*, 310 U.S. 434, 60 S. Ct. 1044, the Court stated the rule at page 1051, as follows:

> "Under Chapter XI only the rights of unsecured creditors of the debtor may be arranged and this without alteration of the status of any other classes of security holders or of subsidiaries."

The above limitation upon jurisdiction does not depend upon any lack of possession of a bankruptcy debtor or trustee. It is inherent in the statutes which specifically limit the jurisdiction.

In the case of *Nixon v. Michaels,* 38 F. 2d 420 (8th Circuit), the Court stated at page 423:

> "A District Court of the United States sitting as a court of bankruptcy is a court of limited jurisdiction. Limitations exist as to subject matter; as to territory; as to residence and occupation of the debtor to be adjudicated; as to the status of the corporation or person to be adjudicated; and as to other matters. Remington on Bankruptcy (3d Ed.) c. III. And consent cannot confer jurisdiction over the subject matter. The express provisions of the statutes and the necessary implications are controlling (citing cases)."

See also:

> 8 *Corpus Juris Secundum,* Bankruptcy, Section 21, at 646.

It is not a question of constructive possession either. The existence of a lien or other security automatically divests the Bankruptcy Court of jurisdiction in a Chapter 11 proceeding.

IV.

Appellee Was Estopped to Attack the Rights of Appellant William J. Clark.

The Referee found that Appellant William J. Clark was not a holder in due course of the promissory note because, at the time he purchased the promissory note, it was then overdue. He also found that William J. Clark could not invoke the defense of estoppel as against the Appellee, even though the first objection which the Appellee made to the promissory note was by way of a Notice of Rescission dated August 9, 1965.

It must be borne in mind that, as late as July 23, 1964, the Appellee, her husband and Charles L. Weaver, Jr. all signed a confirmation of the promissory note in connection with an extension of the due date of such promissory note. [T. p. 39.] We believe that the evidence showed that Mr. Clark had purchased the promissory note and deed of trust in reliance upon this signed confirmation, and that the Appellee was at fault in carelessly permitting the note and deed of trust to go unchallenged until foreclosure proceedings were commenced with respect to the trust deed.

The case of *Kelly v. Universal Oil Supply Co.,* 65 Cal. App. 493, exemplifies the situation involved in the case at bar in that the mortgagors and makers of the promissory note had written a letter similar to the one signed by the Weavers, stating that there wre no offsets or any defense against the note. At that time, under the California law, a note secured by a mortgage was

non-negotiable, and the Court, in taking note of this, nevertheless, held that the makers were estopped to assert any defenses to the enforcement of the note and mortgage. The Court said at page 497:

> " 'Whether a party has, by his own declaration, act, or omission, intentionally and deliberately led another to believe a particular thing true, and to act upon such belief, he cannot, in any litigation arising out of such declaration, act or omission, be permitted to falsify it.' (Code Civ. Proc., sec. 1962, subd. 3.) . . . Their declaration was intended to influence any person who might contemplate the purchase of the securities, and their deliberate failure to disclose any secret equities or conditions relative thereto, of which they had full knowledge, was such an omission of duty as to preclude them from asserting such equities or conditions against one who has been misled by their statement. One form of deceat is 'the suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact.' (Civ. Code, sec. 1710, subd. 3.) It is urged that the bank made no inquiries relative to any equities or conditions attaching to the securities. The answer is that under the written representations made by the plaintiffs, and upon which the bank acted, there was no occasion for inquiry. (Porter v. Johnson, 172 Cal. 456 (156 Pac. 1022).)"

See also:

Sherwood v. Robertson, 48 Cal. App. 208 at 211.

V.

Appellant Does Not Need to Belabor the Question Whether There Was Some Evidence of Fraud.

We have reviewed the transaction sufficiently to indicate that this is not a case where the evidence points only in the direction of fraud. We can concede that the circumstances might have been sufficient to justify a determination of fraud on the Appellant's part. The primary point is that the evidence does not point conclusively in the direction of fraud. Both Perkins and Adrianse, the representatives of Appellant, denied any of the contentions that they had misrepresented this transaction to Appellee. [R.T. p. 477, line 18, to p. 478, line 4 — Perkins; p. 437, lines 15-20 — Adrianse.]

Weaver, Jr. attempted to escape responsibility for any fraud by testifying that he did not personally explain the real purpose of this transaction to his parents, but that he had requested Perkins to do this. There was no Finding as to whether Weaver, Jr. was a party to the fraud of Pasadena Investment Co., and, yet, his participation in this fraud, if any fraud existed, is inescapable. He testified that he had requested the representative of Pasadena Investment Co. to explain to his parents the transaction under which a check was being drawn, payable to the order of Mid-Valley.

In other words, Weaver, Jr. attempted to escape responsibility for any fraud by testifying that he did not personally explain the real purpose of this transaction to his parents, but that he had requested Perkins to do so. [R.T. p. 227, line 24, to p. 228, line 6.] It is incredible that, after signing the note and trust deed on August 28, 1963, Weaver, Jr. would continue to operate Mid-Valley in the feed brokerage business and to suc-

cessfully conceal from his parents the fact that the $51,-027.50 had actually been used by Appellant to repay the unpaid portion of the Hume Lake Cattle Co. note. In any event, Weaver, Jr. would have had to be a party to the initial fraud, as well as to the concealment of the facts which took place thereafter, until around the month of June, 1965, when a Notice of Rescission was sent by Mrs. Weaver, the Debtor.

It is, likewise, difficult to understand how Weaver, Jr. and his two parents could have failed to discuss this transaction for a period of approximately two years after it took place, bearing in mind that there was no showing of any unfriendliness between Weaver, Jr. and his parents. The subject must have come up between the parties during this long period of time as Weaver, Sr. was also financially interested in Mid-Valley and its operations. [R.T. p. 234, line 25, to p. 235, line 1.]

At this point, we should add that neither the Appellee nor her deceased husband should be able to disavow the acts of their agent, Weaver, Jr., even assuming that they had not expressly authorized him to perpetrate any fraud upon Appellant by releasing cattle from the corrals of the Hume Lake Cattle Co.

See also:

Blackburn v. Witter, 201 Cal. App. 2d 518 at 521;

Ghiglione v. American Trust Co., 49 Cal. App. 2d 633;

Bank of Palo Alto v. Pacific Postal Cable Co., 103 Fed. 841 at 846; and

21 *California Jurisprudence* 2d (Agency). Section 156, page 852.

We mention these matters, because Appellant has been the one who has been taken advantage of from the inception, and, yet, it finds itself penalized by having the $51,000.00 note and deed of trust declared void as to both the debtor and her deceased husband. This occurred in spite of the fact that fraud must be proved by the party asserting it and that it is never presumed.

See:

23 California Jurisprudence 2d (Fraud and Deceit), Section 73, pages 182, *et seq.*

This is important, because both Mr. Perkins and Mr. Adrianse of Pasadena Investment Co. denied making any representations to either of the Weaver Srs. regarding the purpose of the $51,000.00 note and deed of trust which was signed by all three of the Weavers. [R.T. p. 477, line 18, to p. 478, line 4; Perkins, R.T. p. 437, lines 15-20; Adrianse.]

Furthermore, Charles Weaver, Jr. admitted that he did not personally hear any representations made by any Pasadena Investment Co. representatives to the Weaver Srs., but that Mr. Perkins stated to him that he would explain the transaction to Mrs. Weaver. [R.T. p. 227, line 24, to p. 228, line 6.]

As an example of the weak evidence which the Referee relied upon to support his determination of fraud, we quote from the testimony of Mrs. Weaver, the debtor, as follows:

> "A. Well, in the first place, my son asked Mr. Perkins to tell us the occasion — for this meeting —
>
> Q. To explain the details? A. To explain the details of this meeting and he explained it that

Pasadena Investment Company was—loan us $51,-000.00 to finance the operations of the Mid-Valley Investment Company—

Q. Mid-Valley Development Company? A. Mid-Valley Development Company, to—as a brokerage firm.

Q. What kind of a brokerage firm? A. They were to sell—handle feed for the cattle in the Hume Lake Cattle lot; at a percentage of course—profit, and it looked as the way they presented it that it—

Mr. Clark: Now I submit that she's going beyond what was said and I move that that be stricken.

The Referee: The answer will be stricken—

Mrs. Weaver: They presented it in a way—

Mr. Clark: Now just—

The Referee: Mrs. Weaver I think perhaps you should—wait for the next question from counsel.

Mr. Dietrich: Q. Now we were referring to conversations with this, that you just related explained to you by Mr. Perkins— A. Yes it was.

Q. —and what else did Mr. Perkins say, if anything? A. Well I can remember one direct quote, he said 'Well we want to see Charles make some money for himself.'

Q. Can you remember specifically anything else that Mr. Perkins said—at this time? A. No, I can't —it was just the general discussion of the way that this would be handled—in the factoring through Pasadena Development Company." [R.T. p. 46, line 5, to p. 47, line 11.]

It will be noted that Mrs. Weaver makes reference to the word "factoring" in her above testimony, and, yet, on the same occasion, she testified that she did not understand factoring at all. [R.T. pp. 48 and 113.] It is, therefore, even more incredible that she would have signed papers concerning a transaction on factoring if she did not understand it. She would at least have asked some questions of someone. Of course, she testified that even though the $51,000.00 proceeds were to be used to repay the Hume Lake obligation and her son's obligation, she would have signed the documents which she did sign if her husband had asked her to do so. [R.T. p. 128.]

It is inconceivable that she and her husband would have come into town and met with the two representatives of Pasadena Investment Co. and her son if they had not been told something about the purpose of their mission, and if it is true that they had been so told, it is more incomprehensible that they would have proceeded to blindly sign the documents without some interrogation of their own son, as this was not an insignificant transaction. It is likewise unbelievable that their son would have concealed his own errors from his parents in releasing cattle from the feed lot and thereby giving rise to this liability. He would normally not be so lacking in courage as to delegate to strangers the function of explaining such matters to his parents without his being present to correct any such explanation or to justify himself.

Regardless of how the decision of the Referee is interpreted, it leads to one positive conclusion, and that is that, if there was any basis at all for fraud as against Pasadena Investment Co., then the Debtor's own son

was not only involved in a grosser type of fraud on his own parents but was so completely lacking in courage as to be unworthy of belief under any circumstances.

It is incredible that, at the time of the signing of a confirmation of the note and deed of trust, approximately one year later, neither of the Weaver Srs. would have known the facts, particularly when Weaver, Sr. was supposed to be a one-half owner of the venture being carried on by Mid-Valley Development Company. Her testimony regarding her discussions with her husband on this subject is as follows:

> "Q. Did you have any discussion with your husband as to why you were signing this document? A. Well, naturally we talked it over." [R.T. p. 107, lines 6-8.]

Conclusion.

This case is anomalous in many respects. It involves a situation where Appellant was defrauded in the sum of $68,000.00 by the act of Weaver Jr. in releasing cattle and thereby destroying the agistor's lien which accompanied the invoices purchased by Appellant. Subsequent to Appellant applying the $51,027.50 to reimburse it for the loss which Weaver, Jr. had caused it, the Debtor filed a Chapter 11 proceedings, although she had no debts to general creditors except a very few nominal ones totaling less than $1,000.00. [T. p. 30, lines 27-29.] Then, with no Receiver or Trustee appointed, the present proceedings were instituted before the Referee in Bankruptcy for the sole purpose of having the $51,000.00 note and trust deed declared void and unenforcible.

Such objective was achieved before the Referee in Bankruptcy, and this was affirmed by the Judge of the District Court. This accomplishment, if permitted to stand, renders no longer necessary the continuation of the Chapter 11 proceedings, because if the deed of trust is eliminated from the Debtor's property, she can dismiss the Chapter 11 proceedings and go forth without further concern over this obligation.

Not only would such a result be achieved, but it would be achieved in a statutory proceeding which has been created for the sole purpose of consummating arrangements with general unsecured creditors. Not only does the Bankruptcy Court lack plenary jurisdiction over such matters, but it lacks any jurisdiction whatsoever where a Chapter 11 proceeding is involved.

It is a prime example of the use of a tribunal for a purpose which was never contemplated by Congress; and the general inadequacy of such a remedy is apparent by the fact that the Referee did all of these things without making any finding as to the guilt or innocence of Weaver Jr. and without being able to make any direction for restitution to Appellant Clark on account of his purchasing the promissory note from Appellant Pasadena Investment Co. He is required by the Referee to rely upon the good faith of a company (Pasadena Investment Co.), found by the Referee to be guilty of fraud, to voluntarily reimburse him for his loss.

We respectfully submit that the decision of the District Court should be reversed and that the order of the

Referee should be set aside with directions to dismiss the proceedings without prejudice to any right on the part of the Debtor to maintain them in a court of proper jurisdiction.

Respectfully submitted,

McLaughlin & McLaughlin,
By James A. McLaughlin,
Attorneys for Appellants, Pasadena Investment Co. and William J. Clark.

Certificate.

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

JAMES A. MCLAUGHLIN

EXHIBITS.

Exhibit No.		Identification	In Evidence
Debtor's	1		20
"	2		21
"	3		21
"	4		23
"	5		23
"	6		23
"	7	24	26
"	8		42
"	9		43
"	10		44
"	11		98
"	12		102
"	13		102
"	14		102
"	15		102
"	16		130
"	17	132	268
"	18	134	154
"	19	135	205
"	20	135	154
"	21	135	154
"	22	136	206
"	23		136
"	24		141
"	25		143
"	26		194
"	27		217
"	28		217
"	29		218
"	30		220
"	31		220
"	32		220
"	33		229

Exhibit No.		Identification	In Evidence
"	34		272
"	35		282
"	36		288
"	37		294
"	38		295
"	39		297
"	40		312
"	41		322
"	42		344
"	43		347
"	44		351
"	45		357
"	46		368
"	47		401
"	48		401
"	49		402
"	50		413
"	51		462
Respondent Pasadena Investment's			
"	A	239	241
"	B		268
"	C		416
"	D		419
"	E		440
"	F		445
Respondent Clark's			
"	I		258
"	II		
"	III		
"	IV		490